

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**AUDIT OF THE
PENSION PLAN AT A TERMINATED
MEDICARE PART B CONTRACTOR
BLUE CROSS AND BLUE SHIELD
OF LOUISIANA**



JUNE GIBBS BROWN
Inspector General

FEBRUARY 1996
CIN: A-07-95-01141



Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

CIN: A-07-95-01 14 1

February 7, 1996

Mr. Carl J. Mautner
Vice President & Controller
Blue Cross and Blue Shield of Louisiana
5525 Reitz Avenue
P.O. Box 98029
Baton Rouge, LA 70809-9029

Dear Mr. Mautner:

This report provides you with the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review titled *Audit of the Pension Plan at a Terminated Medicare Part B Contractor, Blue Cross and Blue Shield of Louisiana*. The purpose of our review was to evaluate Blue Cross and Blue Shield of Louisiana's (Louisiana) compliance with the pension segmentation requirements of its Medicare contract and to determine the excess assets that should be refunded to Medicare as a result of the termination of the Medicare Part B contract.

We identified Medicare Part B segment assets of \$73,562 as of 1986. Additionally, we updated Medicare Part B segment assets from Plan Year 1986 to Plan Year 1990 and identified segment assets of \$206,471 as of January 1, 1990.

Louisiana was the Medicare Part B subcontractor for the state of Louisiana until the contract was terminated effective October 1, 1989. Under the terms of the contract, any differences between the Medicare segment pension assets and actuarial liability at the time the Medicare segment terminated should be refunded to the Medicare program.

We recommend that Louisiana refund \$194,177 of excess Medicare Part B pension assets resulting from the termination of their Medicare Part B contract. Louisiana believed that elements of our calculations resulted in an overstatement of the recommended refund. Louisiana's response is included in its entirety as Appendix B. Appendix C contains the Health Care Financing Administration (HCFA), Office of Actuary's comments on Louisiana's response.

INTRODUCTION

BACKGROUND

Louisiana administered Medicare Part B under cost reimbursement contracts since 1985. These contracts, the Federal Acquisition Regulations (FAR) (which superseded the Federal Procurement Regulations (FPR)) and the Cost Accounting Standards (CAS) contain reimbursement principles for cost reimbursement contracts.

Since its inception, Medicare paid a portion of the annual contributions made by contractors to their pension plans. These payments represented allowable pension costs under the FPR and/or the FAR. In 1980, both the FPR and Medicare contracts incorporated CAS 412 and 413.

The CAS 412 regulates the determination and measurement of the components of pension costs. It also regulates the assignment of pension costs to appropriate accounting periods. The CAS 413 regulates the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

The Health Care Financing Administration incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. The contractual language specified segmentation requirements and also provided for the separate identification of the pension assets for a Medicare segment.

Louisiana's contract required: (1) computing the Medicare segment's actuarial liability, (2) determining the ratio of the Medicare segment's actuarial liability to the total plan actuarial liability (asset fraction), (3) allocating a portion of total pension assets as of 1986 based on the above ratio, (4) updating Medicare pension assets annually, and (5) assessing if Medicare's pension costs should be separately calculated.

The Medicare contracts identify a Medicare segment as:

... any organizational component of the contractor, such as a division, department, or other similar subdivision, having a significant degree of responsibility and accountability for the Medicare contract/agreement, in which:

1. *The majority of the salary dollars is allocated to the Medicare agreement/contract; or*
2. *Less than a majority of the salary dollars is allocated to the Medicare agreement/contract, and these salary dollars represent 40 percent or more of the total salary dollars allocated to the Medicare agreement/contract.*

The contracts also provided for separate identification of the pension assets of the Medicare segment. The identification involved the allocation of assets to the Medicare segment as of the first pension plan year after December 31, 1985 in which the salary criterion was met. The allocation used the ratio of the actuarial liabilities of the Medicare segment to the actuarial liabilities of the total plan, as of the later of: (1) the first day of the first plan year starting after December 31, 1980, or (2) the first day of the first pension plan year following the date such Medicare segment first existed.

The HCFA distributed a pension cost questionnaire to contractors in 1989 to ensure that contractors developed and maintained the data necessary for segmentation calculations. Louisiana's questionnaire response of May 2, 1989 identified total pension assets of \$11,730,475 and Medicare Part A segment assets of \$1,332,699 as of January 1, 1986. However, Medicare Part B segment assets were not identified because of Louisiana's position that as a subcontractor for Medicare Part B a Medicare segment did not exist.

The CAS 413.50(c)(12), addresses contract terminations and provides criteria for closure of a segment. It states:

"If a segment is closed, the contractor shall determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated... The calculation of the difference between the market value of the assets and the actuarial liability shall be made as of the date of the event that caused the closing of the segment. "

Louisiana participates in the National Retirement Program administered by the Blue Cross/Blue Shield National Employee Benefits Administration (NEBA). The Wyatt Company, NEBA's actuarial firm, played a major role in the preparation of Louisiana's questionnaire response.

SCOPE

We made our examination in accordance with generally accepted government auditing standards. Our objectives were to determine Louisiana's compliance with pension segmentation requirements of its Medicare contract, and to determine the amount of excess assets that should be refunded to Medicare as a result of the Part B contract termination. Achieving our objectives did not require a review of Louisiana's internal control structure. We identified the Medicare Part B segment as of January 1, 1988 and traced the segment's organizational lineage back to 1985. We also computed the asset fraction and updated the Medicare assets from January 1, 1986 to January 1, 1990.

In performing our review, we used information provided by NEBA and NEBA's pension actuary. The information included present value of future benefits, present value of future salaries, covered payroll, liabilities, normal costs, contributions, expenses, and earnings. We

reviewed Louisiana's accounting records, pension plan documents, annual actuarial valuation reports, and the Department of Labor/Internal Revenue Service Forms 5500. Present value of future benefits, present value of future salaries, liabilities, and normal costs for the Medicare segment were estimated by the HCFA, Office of the Actuary (HCFA Actuary). Using these documents and estimates, we calculated Medicare segment assets as of January 1, 1991. The HCFA Actuary reviewed our methodology and calculations.

In conjunction with this audit, we reviewed pension costs claimed for Medicare reimbursement (CIN: A-07-95-01 142). The same information was obtained and reviewed during both audits.

We performed site work at Louisiana's corporate offices in Baton Rouge, Louisiana during January and February 1995. Subsequently, we performed audit work in our Jefferson City, Missouri office.

FINDINGS AND RECOMMENDATION

MEDICARE PART B ASSETS AS OF JANUARY 1, 1986

As stated previously, Louisiana did not separately identify Medicare Part B segment assets due to its position that a Medicare segment did not exist. Louisiana based its position on the premise it was a subcontractor for Medicare Part B, not a contractor.

Subcontracts are addressed by FAR Subpart 3 1.103(b), which provides criteria for contracts with commercial organizations. It states:

... the contracting officer shall incorporate the cost principles and procedures in Subpart 31.2 and agency supplements by reference in contracts with commercial organizations as the basis for (1) determining reimbursable costs under (i) cost-reimbursement contracts and cost-reimbursement subcontracts under these contracts performed by commercial organizations..

Therefore, Louisiana was subject to the same contractual requirements as the primary Medicare Part B contractor (Arkansas). Accordingly, Medicare Part B segment assets must be separately identified. The identification involves the allocation of assets to the Medicare segment as of the first pension plan year after December 31, 1985 in which the salary criterion was met. Furthermore, the allocation was to use the ratio of actuarial liabilities of the Medicare segment to the actuarial liabilities of the total plan, as of the later of the first day of the first plan year starting after December 31, 1980, or the first day of the first pension plan year following the date such Medicare segment *first existed*.

In accordance with the contract, we identified the Medicare Part B segment as of January 1, 1988 and traced the segment's organizational lineage back to 1985, the date such Medicare segment first existed. We computed a Medicare Part B asset fraction of 0.6271 percent.

Our calculation identified the Medicare Part B segment assets of \$73,562 as of January 1, 1986. The following schedule shows the details of our calculations.

	1985 Total Actuarial Liability (A)	1985 Medicare Actuarial Liability (B)	1985 Rounded Asset fraction (C) (B)/(A)	1986 Total Company Assets (D)	1986 Medicare Segment Assets (E) (C)x(D)
OIG Calculation	\$8,808,938	\$ 55,244	.006271	\$11,730,475	\$73,562

MEDICARE PART B ASSET BASE AS OF JANUARY 1, 1986 UPDATED TO JANUARY 1, 1990

We updated the Medicare Part B segment assets from January 1, 1986 to January 1, 1990. When considered with the 1986 adjustment, we identified as of January 1, 1990, Medicare Part B pension assets of \$206,471. The increase in pension assets from \$73,562 to \$206,471 resulted from: (1) participants that moved in and out of the segment and transfers to non-active status (\$39,586 decrease), (2) pension plan contributions, earnings, and expenses and (\$206,015 increase), and (3) benefits payments (\$33,520 decrease).

Participants and Transfers

We identified the Medicare Part B segment organizational components and cost centers. We adjusted for participants that moved in and out of the Medicare segment. We also made transfer adjustments for participants that changed from active to non-active status. The following table details our transfer amounts:

Transfer Adjustments To The Medicare Segment

<u>Year</u>	<u>OIG</u>
1986	\$15,770
1987	9,394
1988	392
1989	(65,142)
Total	<u>\$(39,586)</u>

We included the transfer amounts in updating the Medicare segment assets. See Appendix A. Our computation reduced Medicare segment assets by \$39,586.

Allocation of Earnings and Expenses

We allocated investment earnings and administrative expenses to the Medicare segment based on a ratio of segment assets to total company assets. Louisiana used this same allocation methodology in their update of Medicare Part A segment assets (CIN: A-07-95-01 121).

Benefit Payments

We identified the benefits paid to Medicare Part B non-actives and included these payments in our update of the segment's assets. Our identification of benefit payments reduced the Medicare Part B segment assets by \$33,520.

Medicare Part B Assets as of January 1, 1990

We updated pension assets of the Medicare Part B segment from January 1, 1986 to January 1, 1990 (See Appendix A). Our calculation showed Medicare Part B segment assets of \$206,471 as of January 1, 1990.

EXCESS MEDICARE PART B PENSION ASSETS

Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains which occur when a Medicare segment terminates should be credited to the Medicare program. In addition, FAR addresses dispositions of gains in situations such as contract terminations. When excess or surplus assets revert to a contractor as a result of termination of a defined benefit pension plan, or such assets are constructively received by it for any reason, the contractor shall make a refund or give credit to the Government for its equitable share (FAR, section 31.205-6(j)(4)).

Louisiana's Medicare Part B subcontract was terminated effective October 1, 1989. Blue Cross and Blue Shield of Arkansas became the Part B Medicare contractor for the state of Louisiana on October 1, 1989. Most of the pension plan participants of the Medicare segment had their employment terminated or were transferred to the commercial side around the time of the termination of the Medicare contract.

We identified Medicare Part B assets of \$206,471 as of January 1, 1990. We computed the Medicare actuarial liability for accrued benefits to be \$11,455. This amount included the final settlement of lump sum benefits to Medicare participants. Thus, the adjusted Medicare Part B pension assets as of January 1, 1990 were \$195,016. However, the Medicare Part B segment was not 100 percent Medicare.

We determined the Medicare percentage of the aggregate Medicare segment to be 99.57 percent. We calculated the Medicare percentage based on salaries charged to Medicare as shown below:

<u>Fiscal</u> <u>Year</u>	<u>Medicare</u> <u>Salaries</u>	<u>Total</u> <u>Salaries</u>
1986	\$1,721,432	\$1,723,997
1987	1,920,493	1,920,493
1988	2,234,479	2,234,479
1989	<u>2,724,543</u>	<u>2,759,464</u>
Total	<u>\$8,600,947</u>	<u>\$8,638,433</u>

Ratio of Medicare Salaries to Total Salaries is 99.57 percent.

After applying the Medicare percentage to the adjusted assets of \$195,016, the resulting amount of \$194,177 represents the portion of the excess pension assets attributable to Medicare Part B.

Recommendation:

We recommend that Louisiana:

- ❶ Refund \$194,177 of excess Medicare Part B pension assets resulting from termination of its Medicare Part B contract.

Auditee Response

Louisiana generally believed that two elements in our calculation of excess Medicare Pension assets overstated the amount of the recommended refund. Louisiana's points are summarized in the following paragraphs and presented in detail on Appendix B.

First, Louisiana objected to the use of the pension plan interest rate rather than the interest rate promulgated by the Pension Benefit Guaranty Corporation (PBGC) to value the Medicare segment's actuarial liabilities for purposes of the CAS 413.50(c)(12) adjustment. Louisiana argues that use of the more conservative PBGC interest rate is appropriate.

Second, Louisiana stated that the calculation should have used an accrued benefit cost method rather than a projected benefit cost method for valuing the actuarial liabilities of individual Medicare segment employees who remained after the termination of the Medicare contract and subcontract. Louisiana argues that the projected benefit cost method properly considers future salary increases for Medicare segment employees who remain with Louisiana.

OIG Comments

We disagree with Louisiana's two general contentions. Our reasons for disagreeing are summarized in the following paragraphs and the HCFA, Office of Actuary's detailed comments on Louisiana's response are presented on Appendix C.

Regarding Louisiana's first point, the PBGC may only invest in special securities issued by the U.S. Treasury, which yield significantly lower expected investment returns than that of a professionally managed trust. In addition, the methodology used to develop the PBGC rates produces extremely conservative rates. This level of extreme conservatism is only appropriate for an insurer that must guarantee the benefit liability of plan sponsors in critical financial distress. When the pension plan and trust continue, the PBGC assumptions are inappropriate and unreasonable.

For purposes of CAS 413.50(c)(12), the actuarial liability is to be determined using an interest rate based on past experience and long-term expectations concerning the investment yield of the underlying funding mechanism. The actuarial liability used to determine the CAS 413.50(c)(12) adjustment was provided by Louisiana's actuary, The Wyatt Company, and it was based on the interest and mortality valuation assumptions used since 1985. We found no evidence that Louisiana believed its valuation assumptions were unreasonable.

With regard to Louisiana's second point, when a segment closes, there is an end to the causal/beneficial relationship between future pay raises and the Government contract(s). An underlying principle of the CAS, and Government contract accounting in general, has been that there must be a causal/beneficial relationship between the incurrence of a cost and the performance of a contract before that cost can be allocated to and allowed under that contract. Thus, it is inappropriate to recognize future salary increases when determining the 413.50(c)(12) segment closing adjustment.

INSTRUCTIONS FOR AUDITEE RESPONSE

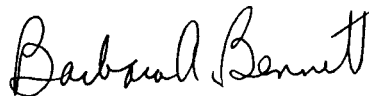
Final determinations as to actions to be taken on all matters reported will be made by the HHS action official identified on the following page. We request that you respond to the recommendation in this report within 30 days from the date of this report to the HHS action official, presenting any comments or additional information that you believe may have a bearing on final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG, OAS reports issued to the Department's grantees and contractors are made available, if

Page 9 - Mr. Carl J. Mautner

requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5.)

Sincerely,

A handwritten signature in cursive script, reading "Barbara A. Bennett".

Barbara A. Bennett
Regional Inspector General for
Audit Services, Region VII

Enclosure

HHS Action Official:

Ms. Rose Crum-Johnson
Regional Administrator, Region VI
Health Care Finance Administration
1200 Main Street, Suite 2000
Dallas, Texas 75202-4348

BLUE CROSS AND BLUE SHIELD OF LOUISIANA
STATEMENT OF MEDICARE PENSION ASSETS
FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1990

Description		Total Company	Other Segment	Medicare Part B	Medicare Part A
Assets January 1, 1986	<u>1/</u>	\$11,730,475	\$10,471,138	\$73,562	\$1,185,775
Contributions		0	0	0	0
Prepayment		0	0	0	0
Earnings	<u>2/</u>	1,863,713	1,663,633	11,687	188,393
Benefits	<u>3/</u>	(2,602,321)	(2,216,807)	0	(385,514)
Expenses	<u>4/</u>	(73,302)	(65,432)	(460)	(7,410)
Transfers	<u>5/</u>	0	86,691	15,770	(102,461)
Assets January 1, 1987		\$10,918,565	\$9,939,223	\$100,559	\$878,783
Contributions	<u>6/</u>	628,852	482,637	63,254	82,961
Prepayment		0	0	0	0
Earnings		530,111	482,563	4,882	42,666
Benefits		(180,389)	(180,389)	0	0
Expenses		(81,245)	(73,958)	(748)	(6,539)
Transfers		0	(2,189)	9,394	(7,205)
Assets January 1, 1988		\$11,815,894	\$10,647,887	\$177,341	\$990,666
Contributions		0	0	0	0
Prepayment	<u>7/</u>	0	(72,192)	30,992	41,200
Earnings		1,624,141	1,463,594	24,376	136,171
Benefits		(187,668)	(187,668)	0	0
Expenses		(83,924)	(75,628)	(1,260)	(7,036)
Transfers		0	1,674	392	(2,066)
Assets January 1, 1989		\$13,168,443	\$11,777,667	\$231,841	\$1,158,935

BLUE CROSS AND BLUE SHIELD OF LOUISIANA
STATEMENT OF MEDICARE PENSION ASSETS

FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1990

Description	Total Company	Other Segment	Medicare Part B	Medicare Part A
Assets January 1, 1989	\$13,168,443	\$11,777,667	\$231,841	\$1,158,935
Contributions	0	0	0	0
Prepayment	0	(38,634)	22,087	16,547
Earnings	3,004,756	2,687,411	52,901	264,444
Benefits	(311,510)	(273,893)	(33,520)	(4,097)
Expenses	(96,318)	(86,145)	(1,696)	(8,477)
Transfers	0	114,451	(65,142)	(49,309)
Assets January 1, 1990	8/ \$15,765,371	\$14,180,857	\$206,471	\$1,378,043

BLUE CROSS AND BLUE SHIELD OF LOUISIANA
STATEMENT OF MEDICARE PENSION ASSETS
FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1990

FOOTNOTES

- 1/ We calculated the Medicare Part B segment assets based on our identification of the Medicare Part A segment and our computed asset fraction (0.6271%). We computed the asset fraction as explained in our finding section of the report narrative.
- 2/ Louisiana provided earning amounts and we verified them to IRS Form 5500 reports. We allocated earnings to the Medicare Part B segment based on the ratio of beginning of year market value of Medicare assets to beginning of year market value of total assets. Louisiana used this same methodology for its Medicare Part A segment.
- 3/ Louisiana provided benefit payment amounts and we verified them to IRS Form 5500 reports. We used actual benefit payments for Medicare Part B segment retirees.
- 4/ Louisiana provided administrative expense amounts and we verified them to IRS Form 5500 reports. We allocated administrative expenses to the Medicare Part B segment on the ratio of beginning of year market value of Medicare assets to beginning of year market value of total assets. Louisiana used this same methodology for its Medicare Part A segment.
- 5/ We identified participant transfers between segments by comparing annual participant valuation listings provided by Louisiana. The listings contained the actuarial liability of each participant at year-end. Our transfer adjustment considered each participant's actuarial liability and the funding level of the segment from which the participant transferred. We calculated the funding level as the assets divided by the liabilities. If the funding level ratio was greater than one, we transferred assets equal to the participant's liability.
- 6/ We obtained total contribution amounts from IRS Form 5500 reports. We allocated the 1987 contribution to the Medicare Part B segment based on the ratio of segment participants' normal costs and accrued liability to total company normal costs and accrued liability. Louisiana used this same methodology for its Medicare Part A segment. Louisiana did not make contributions to the pension trust fund for years 1986, and 1988 through 1990.

BLUE CROSS AND BLUE SHIELD OF LOUISIANA
STATEMENT OF MEDICARE PENSION ASSETS
FOR THE PERIOD
JANUARY 1, 1986 TO JANUARY 1, 1990

- 7/ Louisiana's 1987 contribution to the pension trust fund exceeded the CAS pension costs, thereby creating a prepayment credit. The prepayment remains unassigned and accumulates interest in the pension trust fund until needed to fund future CAS pension costs. We assigned the prepayment in proportion to the CAS pension costs.
- 8/ We obtained the total assets as of January 1, 1990 from Louisiana's update of assets provided by its actuary. We identified Medicare Part B segment assets of \$206,471.

BlueCross BlueShield of Louisiana

An independent licensee of the Blue Cross and Blue Shield Association.

P.O. Box 95029 ~ Baton Rouge, Louisiana 70898-9029 ~ 504/295-2214 ~ FAX 504/295-2557

Carl J. Mautner, CPA
Vice President and
Controller

November 6, 1995

Ms. Barbara A. Bennett
Regional Inspector General for
Audit Services, Region VII
Department of Health and Human Services
Room 284A
601 East 12th Street
Kansas City, Missouri 64 106

Re: Comments by Blue Cross & Blue Shield of Louisiana on Draft Audit
Report Nos. CIN A-07-95-01 121, -01140, -01141 & -01142

Dear Ms. Bennett:

Thank you for affording Blue Cross & Blue Shield of Louisiana ("BCBSLA") this opportunity to comment on draft Audit Report Nos. CIN A-07-95-01 121, -01140, -01141 & -01142. We have carefully reviewed those reports with our outside actuary and with outside counsel knowledgeable about Medicare pension cost matters, and our comments are set forth below. We would be pleased to discuss our comments with you or your staff at your convenience.

Draft Report Nos. CIN A-07-01 121 & -01141

In draft Report No. CIN A-07-95-01121, you recommended that BCBSLA refund to the Government \$647,127 of excess pension assets as a result of the termination of BCBSLA's Medicare Part A contract, which became effective October 1, 1990. Similarly, in draft Report No. CIN A-07-95-01 141, you recommended that BCBSLA refund to the Government \$194,177 of excess pension assets as a result of the termination of BCBSLA's Medicare Part B subcontract on October 1, 1989. These recommendations are purportedly based upon Cost Accounting Standard ("CAS") 4 13.50(c)(12), which provides for an adjustment of previously determined pension costs upon the closing of a segment.

Your auditors calculated the recommended refund for each purported Medicare segment by (1) determining the amount of pension assets attributable to the segment; (2) subtracting from that amount the accrued actuarial liability of employees associated with the segment to determine the amount of the segment's excess pension assets; and (3)

multiplying the segment's amount of excess pension assets by a "Medicare percentage" to determine the amount of the recommended refund.

We believe that two elements of the calculations performed by your auditors should be reconsidered and revised. Because each of those elements caused an overstatement of the refunds that you recommended, we urge you to recalculate the refunds in light of the comments set forth below. We would be pleased to discuss the suggested recalculations with you or your staff in more detail.

The Auditors' Use of the Pension Plan Interest Rate. The first element of your auditors' calculations that should be reconsidered concerns the interest rate that was used to value the Medicare segments' actuarial liabilities for purposes of the CAS 413.50(c)(12) adjustment. The auditors used the pension plan's 9.00% long-term interest rate assumption, rather than the more appropriate interest rate promulgated by the Pension Benefit Guaranty Corporation ("PBGC") for valuing a pension plan's actuarial liability at the time that BCBSLA's Medicare contract and subcontract were terminated. The PBGC rate was 7.25% for each relevant month--January 1, 1990 for Medicare Part B and January 1, 1991 for Medicare Part A. The PBGC rate must be used for two reasons.

First, CAS 413.50(c)(12) requires a comparison between the value of a closed segment's pension assets and the value of its actuarial liabilities. For this calculation, CAS 413.50(c)(12) specifically requires that the closed segment's pension assets be valued at market value as of the date of segment closure. Consistency requires that the closed segment's actuarial liabilities also be valued using an interest rate, such as the PBGC rate, that is consistent with market conditions at the time of segment closure. For example, the auditors' valuation of BCBSLA's Medicare Part A pension assets in a manner that reflects the interest rate environment prevailing on January 1, 1991, while valuing its Medicare Part A actuarial liabilities using the pension plan's higher interest rate assumption, resulted in a meaningless comparison of "apples and oranges." That comparison understated the actuarial liabilities of BCBSLA's purported Medicare Part A segment relative to the value of its pension assets and overstated the Government's share of any required CAS 413.50(c)(12) pension cost adjustment.

For pension funding purposes, BCBSLA values both the assets and actuarial liabilities of its ongoing pension plan using actuarial methods that smooth the effects of short-term fluctuations in market value and market interest rates. For example, in accordance with CAS 412.50(b)(5) and CAS 413.40(b), BCBSLA determines the value of the assets in its ongoing pension plans using an actuarial method that smooths fluctuations in market value and yields actuarial values that may differ significantly from market values. The market values of many BCBSLA pension assets, such as corporate bonds, are sensitive to interest rate fluctuations. The market values of such assets will generally be higher than their actuarial values when the market interest rate is lower than the actuarially smoothed interest rate assumption. On January 1, 1990 and January 1, 1991, the prevailing interest rates were lower than the actuarially smoothed interest rate used by BCBSLA's pension plan.

Similarly, in accordance with CAS 412.50(b)(5), BCBSLA utilizes an interest rate for valuing its pension plan's actuarial liability that smooths the effect that short-term fluctuations in interest rates have on that actuarial liability. A reduction in the discount rate used to calculate the present value of an actuarial liability will increase that present value, while an increase in the discount rate will reduce it. Thus, the present value of the actuarial liability of BCBSLA's pension plan calculated using the actuarially smoothed interest rate would have been significantly less than the present value calculated using the lower market interest rate that was then prevailing.

The CAS 413.50(c)(12) pension cost adjustment did not, however, permit the use of an actuarially smoothed asset value. Instead, it specifically required that "the market value of assets allocated to the segment" be determined "as of the date of the event . . . that caused the closing of the segment." The difference between actuarial asset value and market asset value in part reflects the interest rate environment prevailing on the date of the market valuation. For example, a corporate bond held by the BCBSLA pension plan that was issued with a yield of 9% will increase in market value if the market interest rate decreases to 7.25%, but that increase in market value will not be fully reflected by a valuation method that "smooths" short-term fluctuations in asset value. In contrast, the fair market value of BCBSLA's pension assets on a particular day reflects the interest rate and yield expectations of the marketplace on that date.

In order for a CAS 413.50(c)(12) calculation to be meaningful, the measure of a closed segment's actuarial liability should also reflect the interest rate and yield expectations of the marketplace on the date of the event that caused the segment closing. If not, the actuarial liability will be valued in a manner that is inconsistent with the required fair-market valuation of the closed segment's pension assets.

That inconsistency significantly distorted your auditors' calculation of the recommended refund amounts. Valuing the segments' actuarial liabilities using the pension plan's interest rate assumption, while valuing the pension assets in a manner that reflects the lower interest rates prevailing upon closure of the segments resulted in an understatement of the segments' actuarial liabilities relative to the value of their pension assets. Valuing the Medicare segments' pension assets at market increased the value of those assets, relative to their actuarial value, because that market value reflects the increase in value caused by a reduced interest rate environment. In contrast, valuing the Medicare segments' actuarial liabilities using the plan's ongoing interest rate did not fully recognize the increase in the present value of BCBSLA's actuarial liabilities that resulted from a reduced interest rate environment. Thus, the use of the plan's ongoing interest rate to value the Medicare segments' actuarial liabilities for purposes of the CAS 413.50(c)(12) adjustment resulted in an overstatement of the recommended amount of any refund that may be due the Government as a result of the termination of BCBSLA's Medicare contract and subcontract.

Second, CAS 413.50(c)(12) in effect on the date of the contract and subcontract terminations specifically contemplated that the interest rate promulgated by the PBGC would be used for purposes of the adjustment of previously determined pension costs by providing that "[t]he determination of the actuarial liability shall give consideration to any requirements imposed by agencies of the United States Government." Preamble A to CAS 413, issued in 1977 upon the initial promulgation of CAS 413, explains this provision:

The Board recognizes that, in some cases, the closing of a segment could be associated with a termination of a plan. Several commentators noted that, in such a case, the actuarial liability for that segment could be greatly influenced by regulations developed pursuant to the provisions of ERISA. The standard specifically permits the effect of such regulations to be considered in determining the actuarial liability for the segment.

It should be noted that the provisions of this section are appropriate whenever a segment performing a material amount of Government business is closed, irrespective of whether the closing is caused by the completion of a contract or an organizational change, or whether the closing results in a complete or partial termination of the plan.

The PBGC promulgates an interest rate required to be utilized in determining the actuarial liability of a terminating pension plan at plan termination. This determination is closely analogous to that under CAS 413.50(c)(12), which required a determination of the actuarial liability of a closing segment as of segment closure. Thus, the CAS provision providing that "[t]he determination of the actuarial liability shall give consideration to any requirements imposed by agencies of the United States Government," contemplated the use of the PBGC rate because the use of that rate is required by an agency of the United States Government.

The Auditor's Use of an Accrued Benefit Cost Method for Retained Employees.

The second element of your auditors' calculations that should be reconsidered is their use of an accrued benefit cost method for valuing the actuarial liabilities of individual Medicare segment employees who remained with BCBSLA after the termination of the Medicare contract and subcontract. Consistent with the requirements of CAS 412.50(b)(1) & (2), BCBSLA utilizes a projected benefit cost method to determine its annual pension costs. Under that method, the pension cost attributable to the current year properly reflects the actuarial assumption that certain of the contractor's employees will receive salary increases in future years. In contrast, the accrued benefit cost method used by your auditors is based solely on the pension benefits accrued to date by a pension plan participant, and does not consider the assumed escalation in salaries that is integral to BCBSLA's CAS 412-compliant pension cost method.

For those Medicare segment employees who remained BCBSLA employees following the termination of the Medicare contract and subcontract, the projected benefit cost method is the most appropriate method for valuing actuarial liability. Those employees remain with BCBSLA and will receive salary increases. Under BCBSLA's CAS 412-compliant pension cost method, the pension cost associated with those salary increases was properly reflected in the pension costs incurred prior to the termination of the Medicare contract and subcontract. However, because they used an accrued benefit cost method, the auditors understated the actuarial liabilities associated with employees who remain with BCBSLA; a portion of the actuarial liability generated in prior years by BCBSLA's actuarial cost method for such employees was omitted from the auditors' calculation. Thus, to the extent that the accrued benefit cost method fails to consider the salary increases assumed by the projected benefit cost method, the amounts of the recommended refunds were overstated.

Draft Report Nos. CM A-07-01 140 & -01142

In draft Report No. CIN-07-95-01140, you determined that BCBSLA had undercharged its Medicare Part A contract by \$57,858 of allowable pension costs. Similarly, in draft Report No. CIN-07-95-01142, you determined that BCBSLA had undercharged its Medicare Part B subcontract by \$85,546 of allowable pension costs. BCBSLA has no comments on those reports at this time.

* * *

Thank you again for affording us the opportunity to comment on the draft audit reports. We hope that you will recalculate the recommended refunds as suggested above. We would be pleased to discuss these matters with you or your staff at your convenience.

Sincerely yours,



Carl J. Mautner

cc: James Aasmundstad, DHHS/OIG/OAS
Kevin Dwyer, Miller & Chevalier
Jack Morman, DHHS/OIG/OAS
Robert Rhodes, BCBSA
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M E M O R A N D U M

December 14, 1995

To: Barbara A. Bennett
Regional Inspector General for
Audit Services, Region VII

From: Eric H. Shipley
Office of the Actuary

Subject: Blue Cross Blue Shield of Louisiana's Response to Draft Audit Reports on
Pension Costs Charged to the Medicare Program and the Segment Closing
Adjustment under CAS 413-50(c)(12)

In a letter dated November 6, 1995, Blue Cross Blue Shield of Louisiana (Louisiana) has objected to the dollar finding in the audit report on the closing of their Part A and Part B Medicare Segments, CIN A-07-95-0 112 1 and CIN A-07-95-0 114 1, respectively. They neither concurred with nor disputed the balance of these two audit reports. Louisiana also stated they had no comments on the two audit reports addressing the undercharging of pension costs under their Part A contract and their Part B subcontract, CIN A-07-95-01 140 and CIN A-07-95-01 142, respectively. Their objection to the segment closing finding is twofold in that they assert the actuarial liability used to measure the adjustment should have been determined using:

- 1) the PBGC interest rate applicable to pension plan terminations, and
- 2) projected benefits for employees retained by Louisiana after the closings.

My analysis is based upon both Cost Accounting Standard (CAS) 412 and CAS 413 that were in effect at the time of Louisiana's segment closings. Because of the multitude and complexity of pension issues, the Cost Accounting Standards Board (CASB) developed the accounting standards for pension cost in two stages. The CASB first addressed basic measurement and period assignment issues in CAS 4 12. In CAS 4 13, the CASB addressed how pension costs, which were measured under CAS 412, were to be adjusted for gains and losses and were to be allocated to segments. Consequently, these two standards must be taken together for any analysis to properly reflect the intent of the original Board. Moreover, when the current CAS Board amended CAS 4 12 and 4 13, the two standards were consistently treated as a unit in the Staff Discussion Paper, the

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Advance Notice of Proposed Rule Making, the Notice of Proposed Rule Making, and the Final Rule.

Interest Rate Used to Determine Actuarial Liability

CAS 413-50(c)(12) does not specify the interest rate to be used to determine the actuarial liability. Assumed interest rates, as well as all other actuarial assumptions, are addressed by CAS 412 which says:

“Each actuarial assumption used to measure pension cost shall be separately identified and shall represent the contractor’s best estimates of anticipated experience under the plan, taking into account past experience and reasonable expectations. The validity of the assumptions used may be evaluated on an aggregate, rather than on an assumption by assumption, basis.” - 9904.412-40(b)(2)

“Actuarial assumptions should reflect long-term trends so as to avoid distortions caused by short-term fluctuations.” - 9904.412-50(b)(5)

“If the evaluation of the validity of actuarial assumptions shows that, in the aggregate, the assumptions were not reasonable, the contractor shall: (i) identify the major causes for the resultant actuarial gains or losses, and (ii) provide information as to the basis and rationale used for retaining or revising such assumptions for use in the ensuing cost accounting period(s).” - 9904.4 12-50(b)(7)

Paragraphs 9904.4 12-40(b)(2) and 50(b)(5) make it clear that the CAS Board intended that reasonable, long-term assumptions based on past performance and future expectations be used. Nowhere in either CAS 412 or 413 did the Board provide for immediate-period termination assumptions to be used. While assumptions must be based on long-term expectations, 9904.4 12-40(b)(2) and 50(b)(7) provide that assumptions should be updated based on changes in future economic or population trends and expectations.

The actuarial liability used to determine the 9904-50(c)(12) adjustment was provided by Louisiana’s actuary, The Wyatt Company, and it was based on the interest and mortality

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valuation assumptions used since 1985'. The auditors found no evidence that Louisiana believed its valuation assumptions were unreasonable, although it should be noted that Wyatt had lowered the interest assumption from 9.0% to 8.0% by 1994.

In paragraph 9904.4 13-50(c)(12) the CAS Board states that "the determination of the actuarial liability shall give consideration to any requirements imposed by agencies of the United States Government." The work papers of the original CASB show that the Board and staff were aware that the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) could require a contractor to improve plan benefits upon termination of its pension plan; i.e., fully vest all accrued benefits. The Board reasoned that when an increase in liabilities for such benefit improvements was thrust upon the contractor by the Government, equity demanded that the Government recognize that increase. However in the case of Louisiana, no event, such as a full nor partial pension plan termination, occurred that required or imposed any changes to the benefits provided or to the funding of the benefits. While I agree that the CAS recognizes required benefit improvements, no such improvements were imposed.

Similarly, if the pension plan were terminated with insufficient assets, the Pension Benefit Guarantee Corporation (PBGC) would use different interest, mortality, and retirement assumptions to value the actuarial liability for the benefits which it guarantees. Because the PBGC may only invest in special securities issued by the U. S. Treasury, its expected investment return will be significantly lower than that of a professionally managed trust. In addition, the methodology used to develop the PBGC rates produces extremely conservative rates. This level of extreme conservatism is only appropriate for an insurer that must guarantee the benefit liability of plan sponsors in critical financial distress, where the insurer's only financial recourse for the unfunded benefit liability often is in bankruptcy court. When the pension plan and trust continue, the PBGC assumptions are inappropriate and unreasonable.

Because an enrolled actuary's primary duty under ERISA is to certify to the adequacy of funding of the benefits promised to the pension plan's participants, my experience has been that most pension actuaries build some degree of conservatism into their valuation assumptions. In the second exposure draft on selecting economic assumptions, the Actuarial Standards Board recognized this practice and recommended that such conservatism be explicitly addressed by an assumption for adverse deviation. At the

¹ In 1985, Wyatt prepared two valuations, one based on 8.5% and one on 9.0%. The 8.5% interest assumption was used for both ERISA and CAS purposes for that year.

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close of the Medicare segments, Louisiana chose to continue the funding of the pension liability for former segment employees through a professionally managed trust. The interest assumption is therefore properly based upon the underlying investment decision of the contractor. Louisiana has made a financial decision to retain the investment risk and try to “beat” the long-term conservative interest assumption. Had Louisiana actually purchased annuity contracts, only then would the costs of such contracts have established the actuarial liability since the premium’ would have represented benefit payments to the participants.

For purposes of 9904.413-50(c)(12), the actuarial liability is to be determined using an interest assumption based on past experience and long-term expectations concerning the investments yield of the underlying funding mechanism. Only requirements of agencies of the U.S. Government actually imposed should be reflected in the determination of the actuarial liability. The actuarial liability, as computed by The Wyatt Company based on valuation assumptions as of January 1, 1992, was appropriate for determining the adjustment required by 9904.413-50(c)(12).

Louisiana also asserted that using the market value of assets is inconsistent with the use of ongoing actuarial assumptions. The auditors properly followed 9904.413-50(c)(12) which requires that the adjustment be calculated as the actuarial liability less the “market value of assets”. Contrary to Louisiana’s assertion, this is consistent with the immediate period recognition approach used to determine the adjustment amount.

Pension costs for ongoing segments are measured using the actuarial value of assets. The actuarial value of assets is typically determined based on the change in the market value of assets during the year with some portion of the asset gain or loss deferred to future periods through an amortization process³. Just as the use of the actuarial liability causes all liability gains and losses to be recognized in the current period, instead of deferred to future periods, the use of the market value of assets causes immediate period recognition

² Actually, after adjusting the premium for expected dividends, the resultant actuarial liability may have only differed from the liability used in the audit report by the cost assessed by the insurer for full risk assumption and profit.

³ While there are many methods used to determine the actuarial value of assets, all methods share the attribute that some portion of the difference between the value of assets used for measurement of the annual cost and the true market value is deferred to future periods.

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of all asset gains and losses. The CAS Board recognized that when a segment was closed there would be no future accounting periods in which to adjust gains and losses, and therefore adopted the immediate period recognition for segment closings.

Estimation of Actuarial Liability for Retained Employees

The CAS in effect at the time the Medicare segments closed required that the 9904.4 13-50(c)(12) adjustment of previously determined pension costs be measured using the actuarial liability, but was silent on whether the actuarial liability recognized benefit increases due to future salary increases. Reading CAS 412 and 413 together, I note that 9904.4 12-50(b)(6) stated:

“Pension cost shall be based on provisions of existing pension plans. This shall not preclude contractors from making salary projections for plans whose benefits are based on salaries and wages, or from considering improved benefits for plans which provide that such improved benefits must be made.”

The language of this paragraph permits the contractor to anticipate future salary increases, but does not require that these increases be anticipated. Thus this paragraph allows the contractor to prefund a portion of the associated benefit increases and achieve a smoother, and therefore more consistent, pattern of pension costs between contract accounting periods. Anticipating salary increases while the segment is ongoing is appropriate since the salaries being anticipated have a causal/beneficial relationship to work performed under Government contracts. And indeed, this is the basis on which Louisiana previously determined its pension costs and allocated them to the Medicare contracts.

However, when a segment closes, there is an end to the causal/beneficial relationship between future pay raises and the Government contract(s). A contractor may make a management decision to retain productive employees and to assign them to commercial lines of business. Commercial customers then benefit from the future productivity of these retained employees and are responsible for the costs associated with the salary increases paid for the future productivity. An underlying principle of the CAS, and Government contract accounting in general, has been that there must be a causal/beneficial relationship between the incurrence of a cost and the performance of a contract before that cost can be allocated to and allowed under that contract. Thus, it is inappropriate to recognize such future salary increases when determining the 9904.4 13-50(c)(12) segment closing adjustment.

Please call me at (410)-786-6381 if you have any questions.